support the foregoing legal analysis. Basic service is almost universally offered on an unscrambled basis without the need for any terminal equipment. A relatively inexpensive converter box may be provided to some basic subscribers to function as an extended tuner when signals of the basic tier extend beyond the tuning range of the tuner built into the subscriber's television set. Accordingly, rates for such equipment properly fall within Section 623(b)(3).[41]

In contrast, addressable boxes, which are used primarily to receive per-channel services, provide sophisticated electronic technology and signal security features which go beyond the simple tuner extension function of basic converters. Accordingly, addressable boxes are more expensive than converter boxes and the cable operator will provide addressable terminals only to those subscribers whose level of service demands addressability. If an addressable box is provided only to subscribers who desire per-channel services, the equipment rate charged to that subscriber should not be subject to rate regulation (except as required by the anti buy-through requirement).[42]

Further, technological progress will surely suffer if the rates for sophisticated addressable equipment are subject to such

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[41]47 U.S.C. 543(b)(3).

[42]Cf. 47 U.S.C. § 543(b)(3).

regulation.[43] The fact that an addressable box passes the signals from all service categories -- basic, cable programming, and per-channel -- is merely a consumer-friendly convenience which avoids the need to provide an A/B switch or, indeed, even a second set-top converter. Moreover, innovation in equipment technology demands the economic incentives of free market pricing; actual cost rate regulation would be a cumbersome and inadequate substitute. Indeed, if the Commission fails to reconsider its position that all equipment that passes basic tier signals is subject to "actual cost" based regulation, it is likely to create a marketplace incentive for the development of equipment that passes only cable programming or per-channel services. Such a result would be a step backward, not a step forward, for the consumer.[44]

In a related matter, Time Warner requests that the Commission reconsider its decision in ¶ 298 of the Order that the sale of equipment by cable operators is subject to actual cost regulation. The 1992 Cable Act provides for the regulation of rates for the installation and lease of equipment; it does not

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[43]In its Order, the Commission recognized that Congress did not intend for the FCC to inhibit the development of equipment innovations. See Order at n. 671.

[44]In addition, the Commission's position is contrary to the congressional goal of furthering the compatibility between TV sets and cable equipment since it produces incentives to provide equipment in inefficient ways. See 47 U.S.C. § 544A.

address regulation of the sale of equipment.[45] Therefore, the Commission is not empowered to establish such rate regulation.[46] Further, there is no public interest justification for such regulation since there already exists an especially competitive national market for the type of cable equipment that would be sold by cable operators to subscribers.[47]

V. THE "EQUIPMENT BASKET" CONCEPT IS FUNDAMENTALLY FLAWED.

The Commission's benchmark approach regarding equipment, as set forth in Section 76.923 of its rules, directs cable operators the 12 months ending as of the date you last closed your books." This approach creates an arbitrary and unfair distinction between a system which has undertaken significant new construction in the last 12 months, and thus has incurred very high installation expenses, and a mature system with low churn which may have incurred very low installation expenses during the same period. Operators should be allowed to use pro forma expense figures averaged over the life of the franchise to avoid such anomalous results.

The problems with the Commission's equipment basket approach are compounded when equipment costs are "unbundled" from service rates on worksheet 3, which requires the operator to reduce its base rate per channel to exclude costs associated with installation and lease of equipment to subscribers. Thus, systems which have recently installed numerous new subscribers, for example, will be required to "back out" substantial amounts from their maximum allowable rate, even if they did not recover the full cost of such installation, which would typically be the case given industry practice to charge below cost for installations as an inducement to subscription. Even if operators begin charging actual cost for future installations, this will not recoup installation expenses incurred by systems which are now mature.

Similarly, if a system has recently placed substantial numbers of expensive addressable converters into service, those capital costs will have to be backed out of the maximum initial permitted rate, even if the operator purchased such converters intending to recover the costs gradually over time through the monthly cable service charge. After unbundling, however, whereby a separate monthly fee must be assessed for the converter, numerous customers may downgrade to service levels not requiring a converter, and the operator's sunk costs will be unrecoverable. Moreover, the entire equipment basket concept is unfair in that it builds in significant regulatory lag by not allowing costs incurred in a given year to be recovered, at the earliest, until the following year.

The Commission's treatment of additional outlet charges is equally unfair and arbitrary. As the Commission notes, "[w]e recognize that there are costs associated with designing and building a cable system that can provide a signal strong enough to serve more than one outlet in a home . . . If a subscriber requests additional connections that exceed network design capabilities and require additional customer premises equipment, the cable operator may recover the costs of the additional equipment through an additional connection charge."[48] The fallacy with this approach is that cable operators have designed their systems to deliver adequate signal to the number of additional outlets which can be expected, based on past experience, to be requested by subscribers when the price of the

[48]Order at ¶ 307.

additional outlet is set at a market level. However, now that additional outlets essentially must be given away, the demand can be expected to rise. Thus, most systems simply have not been engineered with sufficient signal level to deliver service to [illegible] rulemaking power" to ensure that the rates for the basic service tier are reasonable.[50] However, Congress was careful to set strict limits on the power to regulate cable rates. This is reflected in the plain language of the 1992 Cable Act, which states: "No Federal agency or State may regulate the rates for the provision of cable service except to the extent provided [herein]. . . . Any franchising authority may regulate [rates] . . . but only to the extent provided under this section."[51]

With this directive in mind, it is telling to note that nowhere in the 1992 Cable Act did Congress provide for refunds of similar provision for basic cable service must be read to reflect an intent by Congress not to authorize refunds for this category of service.[54]

Although the Commission acknowledged this argument, it was dismissed without justification or explanation. The Commission summarily remarked:

> [W]e do not believe that the Cable Act's explicit reference to refund authority regarding cable programming service rates and the omission of similar language regarding basic cable rates bars refunds of unreasonable basic service tier rates. The absence of a requirement need not be construed as a prohibition.[55]

As discussed above, the plain language of the Act permits rate regulation only to the extent provided for by Congress. Thus,

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[53](...continued) finds that cable subscribers have been paying unreasonable rates it is only fair that the portion of those rates which are deemed unreasonable be refunded." 138 Cong. Rec. S.654 (Jan. 30, 1992) (statement of Senator Metzenbaum) (emphasis added). This mirrors Section 623(c) of the 1992 Cable Act which directs the Commission to regulate unreasonable cable programming service rates. The legislative history offers no indication that basic rate regulation by franchising authorities was intended to involve refunds.

[54]Moreover, such a reading is consistent with the differing regulatory schemes Congress established for basic tier and cable programming services. In regulating cable programming services rates, Congress adopted an approach based on an after-the-fact complaint procedure. As such, refunds to subscribers are a logical remedy. In contrast, Congress adopted a forward looking regulatory approach as to the basic service tier. Because Congress established a framework quite different in this case, it is understandable that Congress did not envision, and therefore did not authorize, refunds for the basic service tier.

[55]Order at ¶ 141 (emphasis added).

contrary to the Commission's unsupported assertion, the "absence" of refund authority for basic cable rates must be construed as a prohibition.

In light of the Commission's obvious failure to address the substance of this argument, Time Warner urges the Commission to reconsider this issue. Because it is clear that the 1992 Cable Act provides no statutory basis for refunds of basic tier rates, and such refunds would be contrary to Congressional intent, Time Warner urges that the Commission to reverse its position and prohibit franchising authorities from ordering such refunds.

VII. COMPLAINTS FOR REFUNDS ON RATES OF CABLE PROGRAMMING SERVICES SHOULD BE RESOLVED WITHIN SPECIFIED TIME LIMITS.

period prior to that decision, which ever is shorter.[58] This proposed amendment will encourage the FCC to resolve these claims on an expedited, timely basis and will result in quick relief for subscribers adversely affected by unreasonable rates; it is also in the interest of cable operators because it would reduce the amount of contingent liability and the accrual of interest on refund liability.[59]

As the Commission has acknowledged, contingent liability for refunds can be an unfair burden on the operator. In explaining the one-year liability limit imposed on basic rate refunds, the Commission stated that "potentially exposing an operator to refund liability for several years . . . could affect the viability of the cable system."[60] This same concern applies with equal force in the nonbasic refund context. Under the Commission's current nonbasic refund rule, a cable operator could face contingent liability for refunds for several years (i.e.,

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[58]Time Warner also requests that the Commission impose a six-month limitation on refund liability pursuant to a complaint on rate increases. The six-month period is reasonable in that it reduces the cable operator's period of contingent liability and may provide quick relief for subscribers.

[59]Time Warner notes that a franchising authority suffers no monetary penalty for submission of an unjustified non-basic rate complaint. Under the circumstances, placing some cap on the contingent liability faced by the operator during the pendency of such complaints is both fair and appropriate.

[60]Order at ¶ 142.

the period from the filing of a complaint until its resolution).[61] No matter what the ultimate outcome of the proceeding, this contingent liability will adversely affect the cable operator's ability to secure or maintain financing encourage the Commission to resolve rate complaints on a timely basis, thereby providing quicker relief for subscribers than under the current rules. In addition, a timely resolution of refund liability will reduce the operator's administrative burden of locating subscribers who were directly affected by the unreasonable rates. In turn, this will further the practical implementation of the Commission's preferred remedy -- a direct refund to those subscribers affected by the unreasonable rates.[63]

VIII. RETRANSMISSION CONSENT FEES PAID TO BROADCASTERS SHOULD BE TREATED AS EXTERNAL EXPENSES IN THE FIRST YEAR.

The Commission correctly determined that retransmission consent fees paid by cable operators should be treated as external costs, permitting operators to directly pass on these new costs to subscribers without a cost of service showing. Surprisingly, however, the FCC excluded the treatment of retransmission consent fees as external costs <u>in the first year</u> by limiting the pass-through to new or additional fees beyond those already in effect on October 6, 1994.[64] Time Warner believes that there is no rational basis for distinguishing between retransmission consent fees paid in the first year and those paid in subsequent years. Nor is there any basis to distinguish retransmission consent fees from any other

[63]<u>Order</u> at ¶ 376 ("To the extent refunds to actual subscribers who paid the overage is practicable, this is the

programming cost increases. Accordingly, Time Warner asks that this issue be reconsidered, and urges the Commission to treat retransmission consent compensation as a recoverable cost in the first year.

The Commission speculated that excluding retransmission consent costs from external treatment would provide an incentive for cable operators to negotiate aggressively for the lowest fee to which a broadcaster would agree. At the same time, the FCC acknowledged that this approach would also increase the risk that retransmission consent agreements would not be reached and some broadcast signals might not be carried. After weighing these considerations, the Commission decided that treating retransmission consent fees as external costs, but only after the initial transition to retransmission consent is completed, strikes the best balance between these competing interests.[65]

However, in excluding first-year retransmission consent costs from the category of costs that a cable operator may pass-through, the Commission has erroneously assumed that the price for cable service would be no different if retransmission consent costs had been incurred historically. In reaching this conclusion, the Commission assumed that "current cable rates reflect the _value_ of broadcast signals to cable operators."[66]

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[65]_Order_ at ¶245-246.

[66]_Order_ at ¶ 247 (emphasis added).

The Commission's assumption misses the point. As Dr. Kelley notes in his study, basic rates are set under the Commission's rules by reference to the rates charged by competitive firms.[67] One consequence of the presence of competition is that competitive firms presumably are unable to recover the implicit value of the over-the-air signals for which they have not incurred costs.[68] Thus, what is relevant is that the cost of obtaining broadcast programming, apart from copyright payments and technical requirements, has historically been zero.[69] Retransmission consent agreements represent an entirely new cost for cable operators. Accordingly, operators should be permitted to pass-through such programming costs like any others.[70]

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[67]Kelley, "Economic Issues Raised by the Further Notice" at p. 11.

[68]Id.

[69]The additional "value" to consumers in the cable carriage of local broadcast signals, in fact, is found in improved reception. The value of improved reception, in a competitive model, is equal to the costs incurred to ensure that improved reception, i.e., plant costs, signal quality standards, shielding equipment, etc.

[70]In evaluating programming costs other than retransmission consent, the Commission reasoned:

> Treatment of programming cost increases as external costs would assure programmers' continued ability to develop, and cable operators' ability to purchase, programming. The risk with this approach is that cable operators may incur excessive programming costs and then pass them on to subscribers. We believe, however, that cable operators also have incentives to assure that service rates are not excessive since excessive programming costs, if passed on to subscribers, may

(continued...)

In sum, retransmission consent fees established in the first year represent new programming costs, mandated by statute, for which a cable operator can never recover under the Commission's current scheme. Time Warner argues that because treating retransmission consent costs differently in the first year is arbitrary, discriminatory as to other programming costs, patently unfair to regulated cable operators, and contrary to Congressional intent, this decision should be reversed.

IX. THE COMMISSION'S RULES FOR DETERMINING LEASED ACCESS RATES REQUIRE CLARIFICATION.

Time Warner also believes that the Commission's rules addressing the maximum reasonable rates for leased access channels must be further developed or revised.

First, as a general matter, the Commission should be mindful of Congress' admonition that cable operators be allowed to establish the price, terms and conditions for the use of leased channels so as not to "adversely affect the operation, financial condition or market development" of cable systems.[71] To adequately conform to this Congressional directive, which was

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[70](...continued)
cause them to lose subscribers. On balance, we attach greater importance at this initial stage of rate regulation to assuring the continued growth of programming. Order at ¶ 251.

This reasoning is no less true for retransmission consent fees in the first year.

[71]47 U.S.C. §532(c)(1).

unchanged by the 1992 Cable Act, the FCC's rules should recognize that their provisions may not be sufficiently flexible to account for each circumstance that cable systems may encounter in identifying the maximum reasonable rates for leased access.

<u>Second</u>, the Commission's separation of programmers into three distinct categories for the determination of maximum reasonable rates should be eliminated. Although the Commission does not explicitly state its rationale, it apparently created three separate categories because it believes the leasing issues vary depending on the nature of programming provided.[72] Although there are certain differences among types of programming, these differences in no way justify different maximum rates for the different types of programming. The value of each leased access channel is the opportunity cost imposed on the operator from the [illegible]

crafted to segregate the two potentially most lucrative classes of programmers, premium movie services and home shopping, leaving a broad "other" category with an "implicit" fee which may be substantially below a reasonable level (and in some circumstances, below cost).

Third, the maximum reasonable rate standard must be tailored to accurately meet the Commission's intention of calculating the "implicit fee that the programmer pays to be carried on [a] system".[73] The Commission stated that the implicit rate should be calculated by subtracting "the monthly price per subscriber that a cable operator pays to carry . . . programming" from "the monthly price subscribers pay to view that programming".[74] There are various elements that comprise the price subscribers pay that do not appear to be accounted for in the Commission's sample calculations set forth in the Order at ¶518, n. 1312. The Commission should clarify that the examples set forth in the Order at n. 1312 are merely illustrative. Moreover, the Commission should make clear that where an explicit fee analogue for pricing comparisons exists, as it does on many systems that carry home shopping networks, the maximum explicit fee can be used in determining the maximum leased access rate, in lieu of an implicit fee.

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[73]Order at ¶ 517.

[74]Id. Section 76.970(c) of the Commission's Rules as currently drafted needs to be revised. It incorrectly states the opposite -- that the implicit fee is determined by subtracting the monthly price subscribers pay to view programming from the monthly price per subscriber that the operator pays to carry the programming.

CONCLUSION

For the reasons set forth above, Time Warner requests that the Commission reconsider its Order in this proceeding.

Respectfully submitted,

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ECONOMETRIC ASSESSMENT OF THE FCC'S BENCHMARK MODEL

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I. INTRODUCTION

The FCC concludes from its econometric analysis that "rates of systems not subject to effective competition exceed competitive levels by approximately 10 percent on an average industry basis."[1] Using the FCC's model, we found that the competitive effect varies widely across systems. The true average should be calculated by a method that weights the regression analysis by system size. The result is an average of 6 percent by one weighting method and 3 percent by another. Moreover, the FCC's model is based on an assumption that the competitive effect does not vary across franchises. It is statistically inappropriate to continue to use the model unchanged once this assumption is known to be violated.

The FCC further concludes that rates above the benchmarks predicted by its econometric analysis are "presumptively unreasonable because they exceed the average rates charged by systems subject to effective competition."[2] Even ignoring the incorrect average, the FCC model is arbitrary because it is expected to misclassify 29 percent of systems as above the true benchmark when they are actually below it. This misclassification could be significantly reduced by the development of a more accurate model.

The FCC developed its benchmark formula based on the combined price of basic and higher tiers. The econometric evidence does not show that the higher tiers require regulation. We found that the competitive effect in the basic tier alone produced roughly the same dollar reduction in overall tier prices as the FCC model.

Because the FCC released the data upon which it based its regression (and a corrected version of these data) only within the last two weeks, we have not been able to explore fully all the issues we raise here.

II. THE VARIANCE OF THE COMPETITIVE EFFECT MAKES THE FCC MODEL INAPPROPRIATE

The FCC model is based on 267 "noncompetitive" franchises and 110 franchises subject to "effective competition". The model relates price per channel for basic and cable tier

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1 *Order*, Appendix A, Par. 47 (emphasis added).

2 *Order*, Par 217.

service plus related equipment of each franchise to three system characteristics (number of subscribers, and the number of basic and cable tier channels) and whether the franchise meets the statutory definition of competition. The FCC model assumes there is a constant effect of competition on price per channel across franchises. We found that this assumption must be rejected for franchises in different system size groups.

As we detailed in our earlier paper,[3] small systems (those with less than 10,000 subscribers) and large systems (those with 10,000 or more subscribers) behave quite differently in the way the price per channel of each group is related to the three system characteristics in the FCC model and to the competitive effect. Prices of "noncompetitive" large systems are only 3 percent higher than "competitive" large systems, and this competitive effect is not statistically significant. On the other hand, the competitive effect is 17 percent for small systems and highly significant.[4] These two separate estimates are superior to the single estimate found by the FCC.[5]

Approximately two-thirds of the franchises included in determining the FCC's model are in systems with less than 10,000 subscribers. Less than one-quarter of all cable subscribers population. When we use the FCC's model unchanged except for weighting, the competitive effect is only 3 percent.[7]

The FCC model is not homogeneous in an important way. It can be corrected by estimating separate effects for different system size groups, by weighting the regression by system size or by using another specification that is homogeneous. It is statistically inappropriate to continue to use the model unchanged.

III. A HIGH STANDARD ERROR MAKES THE FCC MODEL QUITE ARBITRARY

The FCC model predicts the price for a cable franchise based on the three system characteristics and assumes that any remaining differences between prices of competitive and "noncompetitive" franchises are due to competition. That is, we can think of the model as first predicting a price for each franchise based on the three system characteristics and then attributing any differences between the prices predicted for "noncompetitive" and competitive franchises to competition. An accurate estimate of these residual competitive differences depends crucially on a model that can accurately predict the price for each franchise.

Failure to have an accurate model has two consequences. First, if variables that determine price are omitted and these variables are correlated with the competition measure in the model, the effect attributed to competition will be biased. For example, suppose systems in suburban areas have lower prices and competitive systems are concentrated in suburban areas while "noncompetitive" systems are more evenly distributed in rural, suburban and urban areas. In this case, the model will confound "suburban" with "competitive" and predict a greater competitive effect than if a suburban variable were included in the model. Given that this model contains only three system characteristic variables, it is likely that there are other price-determining variables and that some of these are correlated with being a competitive system.

Second, the FCC model has a relatively high standard error. The root mean squared error of the FCC model is about 0.25.[8] This means that the true price per channel for a system with particular subscriber and channel characteristics could be 25 percent higher or lower than

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[7] See Appendix to our June 16 Study, Table 5.

[8] The FCC did not report this figure. We derived it by replicating its regression using the updated data disk released by the FCC.

the model predicts within one standard error.[9] Even if the competitive price were known to be 10 percent below the true "noncompetitive" price, the high standard error leaves much room for the franchise price to be poorly predicted before the competitive adjustment is made. Unmeasured factors leave a substantial possibility that a franchise that is above the benchmark is in fact pricing 10 percent below the true expected price for a "noncompetitive" franchise with all its characteristics. This in turn leads to a large overestimate in the number of franchises which will need to have their prices reduced.

We have estimated this effect using the FCC data. For each franchise estimated to be above the benchmark the probability of misclassification, i.e., the probability that the difference between the benchmark and the true price per channel adjusted for unmeasured factors is actually zero or less.[10] The average probability that observations above the benchmark have been misclassified is 29 percent. We find that of the 261 "noncompetitive" observations in the regression, 205 are above the benchmark. Based on this probability, 59 of the 205 would actually

For example, inclusion of a churn variable (installation, reconnects and disconnects per customer) is statistically significant.[12] Systems having higher churn have higher prices per channel. Addition of this variable lowers the root mean squared error from 25 percent to 23 percent. This reduction in turn lowers the expected number of inappropriately regulated firms by 5 percent. No doubt other variables like this one exist, or could be developed.

With enough effort, the error could probably be lowered substantially. We emphasize, however, that we do not know if it could be lowered sufficiently to keep the benchmark from arbitrarily misclassifying large numbers of franchises.

IV. THE ECONOMETRIC EVIDENCE IS CONSISTENT WITH REGULATION OF ONLY THE BASIC TIER

Nothing in the FCC methodology (as opposed to the specific equation used) requires the regulated sector to include all service tiers. Further, the econometric evidence that higher tiers require regulation is much weaker than for the basic tier. We have estimated the FCC specification separately for the first tier (including all equipment) and a combination of subsequent tiers, with added variables in subsequent tiers to reflect the number of total channels and satellite channels in basic.[13] The basic service model gives results roughly consonant with the combined model in terms of competitive effect, i.e., regulating only the basic tier reduced the total tier price by about as much as regulating all tiers. The effect of competition in the higher tiers is both smaller in magnitude and much less precisely measured than the basic service effect. This may indicate that higher tiers are more competitive than the basic tier even without the existence of "effective competition".

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[12] See Appendix Table 1.

[13] See Appendix Tables 2 and 3.

APPENDIX